No. 08-1404

Supreme Court, U.S.
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In The
Supreme Court of the United States

DEVON ENERGY CORPORATION,
Petitioner,

v.

KENNETH L. SALAZAR,
SECRETARY OF THE INTERIOR,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF OF AMERICAN PETROLEUM INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

Jonathan A. Hunter
Counsel of Record
Jason R. Johanson
LISKOW & LEWIS
701 Poydras Street
Suite 5000
New Orleans, Louisiana 70139
(504) 581-7979

Harry M. Ng
Erik G. Milito
AMERICAN PETROLEUM INSTITUTE
Office of General Counsel
1220 L Street, N.W.
Washington, D.C. 20005
(202) 682-8000

Counsel for Amicus Curiae

June 15, 2009

THE LEX GROUPDC • 1750 K Street N.W. • Suite 475 • Washington, DC 20006
(202) 955-0001 • (800) 815-3791 • Fax: (202) 955-0022 • www.thelexgroupdc.com

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I. INTEREST OF AMICUS CURIAE

The American Petroleum Institute ("API") is the primary trade association of the oil and gas industry. API's more than 400 members conduct much of the production, refining, marketing and transportation of petroleum and petroleum products in the United States. Together with its member companies, API is committed to ensuring a strong, viable U.S. oil and natural gas industry capable of meeting the energy needs of our nation in an efficient and environmentally responsible manner.

API submits this amicus brief in support of the Petition for a Writ of Certiorari of Petitioner Devon Energy Corporation ("Devon").[1] API submits this brief to address a matter that is critical to its members and to all federal oil and gas lessees: to-wit, the unlawful decision by the Department of the Interior ("Interior") retroactively to reverse, without any opportunity for notice and comment, the agency's established regulatory interpretation concerning the valuation of gas produced from federal lands.

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[1] Pursuant to Supreme Court Rule 37.6, amicus curiae certifies that no counsel for a party authored this brief in whole or in part, and that no person or party, other than amicus curiae, its members, or its counsel made a monetary contribution to the preparation or submission of this brief. Although Devon is a member of API, Devon has not made any financial contribution to cover the costs incurred by API in preparing this amicus brief. Counsel of record for all parties have consented to the filing of this brief, and letters of consent have been filed with the Clerk.

API's members and hundreds of other non-member companies and individuals own oil and gas leases administered by Interior that cover billions of acres of onshore and offshore federal lands. Federal lessees pay billions of dollars in royalties to Interior each year through monthly royalty payments based on the "value of production saved, removed, or sold" from leased lands, as determined by Interior's regulations. In connection with these payments, federal lessees must file monthly reports with Interior containing thousands of lines of data regarding the location, volumes, and values of production. API's members and all other federal lessees take great care in preparing these payments and reports, as non-compliance can expose a lessee not only to a claim for underpaid royalties and interest, but potentially to penalties as well.

Given the legal consequences, detailed regulatory reporting burden, and financial impact of Interior's royalty valuation system, the reliability and predictability of that system are critical for all federal lessees, including API's members. Although Interior's regulations are detailed, they do not address every important issue. Accordingly, when Interior announces an interpretation of its regulations, and instructs lessees that they must follow that interpretation, it is essential for federal lessees to be able to rely on such direction. Interior's regulatory interpretations are of significant importance to API's members and all federal lessees in making financial planning and investment decisions. It is especially important that API's members and all other federal lessees, having performed in reliance on Interior's well-established

regulatory interpretation, not be required retroactively to recalculate the value of production, pay additional royalties and interest, and revise the voluminous data contained in their previously-filed reports, simply because Interior has changed its mind. Given the interest of API's members in the predictability and certainty of their royalty payment and reporting obligations, API's members are vitally interested when Interior seeks retroactively to repudiate a consistently-applied interpretation of its valuation regulations.

II. SUMMARY OF ARGUMENT

API agrees with Petitioner Devon that this Court should grant a writ of certiorari on the questions presented in the Petition. API submits this brief to highlight additional reasons why review of this case is appropriate and necessary. This Court should grant the Petition to resolve conclusively the following issue of administrative law that – given the circuit split on the issue – is badly in need of this Court's authoritative voice: Whether an agency must engage in rulemaking and must abide by the notice and comment procedures of the Administrative Procedure Act ("APA") when the agency fundamentally alters the agency's definitive and consistently-applied initial interpretation of its regulations. This Court should additionally grant the Petition to find that an agency may not give retroactive effect to its new, contrary interpretation of its regulations.

This case concerns Interior's unlawful departure from an authoritatively-established

interpretation of its regulations that govern a federal lessee's duty to pay royalties on natural gas. After eight years of instructing federal lessees regarding the proper deduction of dehydration and compression costs from the royalty value of natural gas, Interior simply changed its mind and ruled that Devon could not deduct such costs. API respectfully urges the Court to grant a writ of certiorari to clarify that an agency's 180-degree deviation from its established regulatory interpretation violates Section 553 of the APA. 5 U.S.C. § 553.

A grant of certiorari here will provide guidance to the lower federal circuit courts, which are split as to whether an agency's reversal of its long-standing regulatory interpretation violates the "notice and comment" rulemaking requirements of Section 553. The decision below, *Devon Energy Corp. v. Kempthorne*, 551 F.3d 1030 (D.C. Cir. 2008),[2] is erroneous in concluding that Interior did not need to follow the notice and comment requirements of Section 553 of the APA when it departed from its longstanding interpretation of its valuation regulations. The decision below conflicts with – at the very least – the opinion of the United States Court of Appeals for the Fifth Circuit in *Shell Offshore, Inc. v. Babbitt*, 238 F.3d 622, 629 (5th Cir. 2001). API respectfully submits that the Fifth Circuit is correct and that, when a federal agency has adopted a definitive interpretation of a regulation, "the APA requires an agency to provide an opportunity for notice and comment before

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[2] The opinion is attached as Exhibit A to the Devon Petition.

substantially altering a well established regulatory interpretation." *Id.* Interior has never denied that it deviated from its consistently-applied interpretation that allowed the deduction of dehydration and compression costs; instead, Interior has argued in the courts below that its original regulatory interpretation was an "unauthorized" "interpretive error" contained within "internal memoranda between subordinate agency officials." However, the record and a series of Interior rulings plainly demonstrate otherwise. Accordingly, this Court should grant the Petition for a Writ of Certiorari to determine that Interior unlawfully failed to follow the notice and comment rulemaking procedures mandated by Section 553.

Even aside from Section 553, Interior's retroactive alteration of its regulatory interpretation was "arbitrary and capricious" under Section 706 of the APA and violative of this Court's precedent. 5 U.S.C. § 706. This Court, the lower federal courts, and Interior itself have frequently held that an agency's retroactive departure from an established agency position violates Congress's prohibition against "arbitrary and capricious" agency conduct. For this reason alone, more fully articulated below, this Court should grant the Petition for a Writ of Certiorari.

Indeed, if the erroneous decision below is allowed to stand, the national impact is enormous. Federal onshore and offshore lessees could now be required to recalculate years of royalty and interest payments at the whim of an agency official's re-interpretation of the royalty valuation regulations.

That result would disregard the federal lessees' reliance interests and reasonable expectations that, by following explicit agency guidance, the royalty payments that they had been making for eight years were correct. If the Court does not correct the decision below, Interior may now require those lessees to expend the time, money, and manpower to recalculate those payments and remit to Interior additional royalties and interest in degradation of prior instructions on which API's members relied. In sum, the split in the lower federal circuit courts, the improper retroactive application of Interior's re-interpretation of its royalty valuation regulations, and the national impact that the erroneous decision below will have if allowed to stand all warrant review by this Court.

III. ARGUMENT

1. Interior's Departure From Its Established Regulatory Interpretation Violated The Notice And Comment Requirements Of Section 553 Of The APA And Warrants Review By This Court.

In both the 1995 Minerals Management Service ("MMS") "Guidance" documents and the 1996 "Dear Operator/Payor" letter, Interior expressly stated that costs of dehydration and compression incurred after gas passed through the royalty measurement point were "transportation costs" that could be deducted from the value on which federal lessees pay royalty. (Petition for a Writ of Certiorari

("Devon Petition") at pp. 5-6.) The 1996 letter left no doubt as to MMS's expectations from industry:

> You must follow these guidelines to ensure proper payment of royalties and correct reporting of production.

(Petition Appendix ("Pet. App.") at 63a.)[3] From 1995 until 2003, Interior consistently interpreted its valuation regulations in the manner articulated in these three documents – *i.e.*, to permit the deduction of dehydration and compression costs as part of a lessee's transportation allowance. This interpretation was consistent with earlier Interior determinations that, under certain circumstances, dehydration and compression could be deductible "transportation" costs. *E.g.*, *Shell Offshore Inc.*, 142 IBLA 71 (1997) (compression deductible); *Exxon Corp.*, 118 IBLA 221, 244 (1991) (dehydration deductible).

In accordance with Interior's administrative decisions and the 1995 and 1996 MMS documents, federal lessees relied on Interior's regulatory interpretation in making millions of dollars of royalty payments, filing innumerable lines of data in their monthly royalty reports, and planning their business operations. As a result, Interior's decisions in 2003 and 2004 *disallowing* Devon's request to deduct the very costs that Interior had consistently

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[3] The letter is attached as Appendix E to the Devon Petition.

allowed turned the world upside down for the regulated community. The APA does not permit this.

As grounds for its complete turnaround on the deductibility of dehydration and compression costs, Interior has argued in the lower courts that its original interpretation was an "unauthorized" "interpretive error" contained within "internal memoranda between subordinate agency officials." Thus, cloaking itself with the assertion that it got the law wrong, Interior seeks to undermine nearly a decade of payments, reporting, and financial planning by federal lessees who relied on the agency's express interpretation.

Devon has effectively briefed to this Court the circuit split that exists in this area of administrative law, and API will not repeat that argument. (Devon Petition at pp. 9-19.) API does emphasize that this Court should grant the Petition to resolve this conflict among the circuit courts because resolution of this issue is critically necessary for federal onshore and offshore lessees. Indeed, resolution by this Court is of the utmost importance as federal lessees cannot be subjected to one standard of administrative law in three circuits and another standard in two other circuits. *Id.*; *Compare SBC Inc. v. FCC*, 414 F.3d 486, 498 (3d Cir. 2005) (requiring that agency comply with notice and comment requirements of the APA "if an agency's present interpretation of a regulation is a fundamental modification of a previous interpretation"), *Dismas Charities, Inc. v. DOJ*, 401 F.3d 666, 682 (6th Cir. 2005) (same), *and Shell*

Offshore, Inc. v. Babbitt, 238 F.3d 622, 629 (5th Cir. 2001) (same), *with Erringer v. Thompson*, 371 F.3d 625, 632 (9th Cir. 2004) (compliance with notice and comment not required), *and Warder v. Shalala*, 149 F.3d 73, 81-82 (1st Cir. 1998) (same).

As the Devon Petition makes clear, the strongest split in the lower federal circuits exists between the opinion below, *Devon Energy Corp. v. Kempthorne*, 551 F.3d 1030 (D.C. Cir. 2008), and the Fifth Circuit's opinion in *Shell Offshore, Inc. v. Babbitt*, which both addressed MMS's change in its established interpretation of its royalty valuation regulations. Indeed, as in Devon's case here, *Shell Offshore* involved MMS's repudiation of its established interpretation of its royalty valuation regulations pertaining to the deduction of transportation costs. 238 F.3d at 624-26. This circuit split in and of itself merits this Court's review of this important question of federal administrative law. *See* Sup. Ct. R. 10(a) (noting that the Court will consider review when "a United States court of appeals has entered a decision in conflict with the decision of another United States court of appeals on the same important matter").

Moreover, the District of Columbia Circuit's decision below conflicts with two earlier opinions from the same circuit and the underlying reasoning in those opinions. *See Alaska Prof'l Hunters Ass'n v. FAA*, 177 F.3d 1030, 1033-35 (D.C. Cir. 1999); *Paralyzed Veterans v. D.C. Arena L.P.*, 117 F.3d 579, 586 (D.C. Cir. 1997). ("Once an agency gives its regulation an interpretation, it can only change that interpretation as it would formally modify the

regulation itself: through the process of notice and comment rulemaking.") Accordingly, not only are federal lessees subject to two conflicting standards of administrative law at the national level, but they are subject to two conflicting standards within the jurisdiction of the District of Columbia Circuit as well.

This Court needs to provide authoritative guidance to the lower federal courts that Section 553 of the APA guarantees Interior's lessees, including Devon and API's members, the right to perform their royalty payment and reporting obligations based on Interior's established regulatory interpretation until the agency changes that interpretation through formal rulemaking procedures. Rather than comply with these APA requirements when it made its 180-degree change in how to value coalbed methane, Interior ignored the APA and made that change unilaterally and retroactively. This precise type of agency conduct – changing the rules in the middle of the game without allowing the input of the regulated community – was held to violate APA rulemaking requirements in *Shell Offshore Inc.*, *Alaska Professional Hunters*, and *Torch Operating Co. v. Babbitt*, 172 F. Supp. 2d 113, 124-25 (D.D.C. 2001). For these reasons, API respectfully asks this Court to grant the Petition for a Writ of Certiorari to resolve the split in the circuit courts and hold that Interior must engage in the notice and comment rulemaking procedures of Section 553 of the APA when it departs from a longstanding interpretation of its valuation regulations.

2. Review By This Court Is Further Warranted Because It Is Arbitrary And Capricious For Interior To Apply Its Changed Regulatory Interpretation Retroactively.

This Court should also grant the Petition for a Writ of Certiorari to conclude that Interior may not apply its new and contrary interpretation of its valuation regulations retroactively. If Interior's decision is upheld, the retroactive reach of Interior's decision could extend not only to Devon, but also to API's member companies. Interior may rely on that decision to require some of API's members to recalculate years of prior monthly royalty payments and pay millions of dollars that, through the Guidance Documents and the Dear Operator letter, Interior had expressly assured API's members were not due. The prohibition against "arbitrary and capricious" agency action in Section 706 of the APA precludes Interior from such retroactive conduct. 5 U.S.C. § 706.

Limitations on the authority of federal agencies to act retroactively are commonly recognized by this Court and the lower federal courts. *E.g.*, *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204 (1988) (holding that federal agency may not promulgate rules with retroactive effect unless Congress explicitly grants such authority); *Retail, Wholesale & Dep't Store Union v. NLRB*, 466 F.2d 380, 390 (D.C. Cir. 1972) (holding that "rule" announced in the course of adjudication can not be applied retroactively without first balancing equitable factors). This prohibition against

retroactivity applies equally to Interior. Indeed, more than fifty years ago, the Ninth Circuit ruled that, because Interior's authority to determine the value of gas for royalty purposes was so extraordinary, Interior could apply a new valuation methodology prospectively only. *Cont'l Oil Co. v. United States*, 184 F.2d 802, 820-21 (9th Cir. 1950). *Cf. S&G Excavating, Inc. v. United States*, 15 Cl. Ct. 157 (1988) (refusing to allow Office of Surface Mining to apply new regulatory interpretation retroactively). Because the D.C. Circuit's decision conflicts with this Court's precedents regarding retroactive agency conduct, review is warranted. *See* Sup. Ct. R. 10(c) (noting that this Court will consider review when "a United States court of appeals . . . has decided an important federal question in a way that conflicts with relevant decisions of this Court").

Interior itself has frequently ruled that it is impermissible retroactively to change the value of oil or gas to the detriment of a federal or Indian lessee. For example, in *Sun Exploration & Production Co.*, 112 IBLA 373 (1990), a federal lessee had used a sliding-scale methodology to value crude oil, which methodology had been applied regularly by Interior during and after the relevant audit period. When MMS then ordered the lessee to recalculate past royalty payments based on a different valuation methodology, Interior's Board of Land Appeals ("IBLA") rejected MMS's retroactive application of this different valuation methodology: "When MMS departs from a prior administrative position and seeks to apply its new position retroactively, it is not enough to state that it has the right to do so." *Id.* at 387.

After the IBLA ruled in *Sun Exploration* that a lessee could not be required to recalculate past royalty payments based on a valuation methodology that was different than the methodology that had been approved contemporaneously with making the royalty payments, MMS acknowledged its obligation to respect industry's reliance on established agency practices:

> After further consideration of IBLA's decision, the Department has determined that it should continue to interpret gross production in a manner consistent with the well-established practice that lessees have historically relied on.

56 Fed. Reg. 63, 661 (1991).

API cannot overemphasize the importance to its members of upholding these recognized restrictions on Interior's authority. Because Interior writes the royalty valuation regulations, because those regulations cannot provide detailed instruction for every factual situation, and because industry's frequent use of new technologies to find, produce, and transport hydrocarbons often creates questions of regulatory interpretation, federal onshore and offshore lessees *must* be able to rely on Interior's consistently-followed regulatory interpretations. If this Court does not grant certiorari to reverse Interior's newly-found retroactive prohibition

against deducting dehydration and compression costs, some of API's members will likely be required to recalculate years of prior monthly royalty payments that complied with Interior's express regulatory interpretation at the time the royalties were originally calculated, simply because Interior changed its mind. The APA protects API's members against such "arbitrary and capricious" agency conduct. *See Atchison, Topeka & Santa Fe R.R. Co. v. Wichita Bd. of Trade*, 412 U.S. 800, 807 (1973) (holding that agency faces difficult burden when it attempts to depart from its "settled course of behavior"); *Acadian Gas Pipeline Sys. v. FERC*, 878 F.2d 865, 870 (5th Cir. 1989) (vacating agency decision because agency, "without a sufficiently articulated justification, impermissibly deviated from past practice"); *Cotton Petroleum Corp. v. DOI*, 870 F.2d 1515, 1526 (10th Cir. 1989) (reversing Interior decision due to Interior's failure to articulate a reasoned explanation for failing to follow established practices and because, "[w]here it is shown that an administrative agency deviated from its established procedures, the presumption of administrative regularity does not apply"). Accordingly, this Court should grant the Petition for a Writ of Certiorari to find that Interior may not apply its new and contrary regulatory interpretation retroactively.

3. A Federal Oil And Gas Lessee's Exposure To Penalties Underscores The Importance Of This Issue Of Federal Law.

A federal lessee must especially be able to rely on Interior's interpretation of its royalty regulations due to a lessee's exposure to penalties under the Federal Oil and Gas Royalty Management Act, 30 U.S.C. §§ 1701, 1719 ("FOGRMA"), as well as a lessee's potential liability under the False Claims Act, 31 U.S.C. §§ 3701 *et seq.* ("FCA"). Under FOGRMA, royalty underpayments "are by definition improper" and may, under some circumstances, subject the payor to civil and/or criminal penalties. *Forest Oil Corp.*, 116 IBLA 176, 182 (1990). Under the FCA, a lessee may be liable if it "knowingly makes, uses, or causes to be made or used, a false record or statement to conceal, avoid, or decrease an obligation to pay or transmit money or property to the Government." 31 U.S.C. § 3729(a)(7). API's members and other industry representatives are frequent targets of FCA relators, a situation that is only exacerbated by uncertainties affecting a lessee's royalty reporting and payment obligations. *See, e.g.*, *In re Natural Gas Royalties Qui Tam Litigation*, 562 F.3d 1032 (10th Cir. 2009); *Maxwell v. Kerr-McGee Oil & Gas Corp.*, 540 F.3d 1180 (10th Cir. 2008). Given this potential exposure above and beyond the royalty payments themselves, it is essential that a federal lessee be able to rely on Interior's established regulatory interpretation.

IV. CONCLUSION

Federal lessees must be able to rely on Interior's expressly-stated and consistently-followed regulatory interpretation. Here, Interior adopted an express interpretation, consistent with numerous other agency decisions, that authorized the deduction of compression and dehydration costs as part of a federal lessee's transportation allowance, and communicated that regulatory interpretation to federal lessees. After publishing its regulatory interpretation to industry, Interior applied that interpretation for eight years. Interior then performed an about-face and ordered the retroactive application of a new and contrary regulatory interpretation.

This Court should grant the Petition for a Writ of Certiorari, ultimately to conclude that Interior's retroactive reversal of its interpretation violates the rulemaking requirements of Section 553 of the APA and Section 706's prohibition against arbitrary and capricious agency conduct. For these reasons, and the reasons set forth by Devon in its Petition for a Writ of Certiorari, API respectfully asks this Court to grant the Petition for a Writ of Certiorari.

Respectfully submitted,

Of Counsel:

Harry M. Ng
Erik G. Milito
American Petroleum Institute
Office of General Counsel
1220 L Street, N.W.
Washington, D.C. 20005
(202) 682-8000

Jonathan A. Hunter
Counsel of Record
Jason R. Johanson
Liskow & Lewis
701 Poydras Street
Suite 5000
New Orleans, LA 70139-5099
(504) 581-7979

Attorneys for American Petroleum Institute